Weekly Comments
Investment Strategy

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Japanese deflation pushes the yen higher

In a climate of intense international uncertainty and though it may seem paradoxical, the yen has reacquired its safe haven status. Despite the extremely poor state of its public finances and its frankly poor outlook for economic growth, Japan is seeing its currency rise against most others—in particular, the dollar and the euro. Below, we examine all of the reasons for the yen's appreciation and its possible repercussions for Japan's economy and the course of monetary policy.

Trend appreciation that is episodically thwarted by yield spreads

The appreciation of the yen, not just against the US dollar but also its nominal effective exchange rate (NEER), is not a new phenomenon. Since the beginning of the critical phase of the financial crisis—i.e., since the summer of 2007—the yen has gained anywhere from 41% to 46% depending on the currency basket we are looking at. However, this movement upward appears to be accelerating. In the first eight months of the year, the yen has appreciated by more than 20% versus the euro and by 8.2% versus the greenback. Indeed, against the dollar the yen has almost reached historically high levels (80.6 in terms of daily data, falling below 80 during market trading in mid-April 1995).

From a macroeconomic perspective, the Unit Labour Cost (ratio of wages to productivity) gap between two countries is a major determinant of the bilateral exchange rate over the medium and long terms. The more a country's ULC falls relative to that of its competitors, the more its relative prices will weaken and the external value of its currency will appreciate. Since 1985, ULCs have contracted by 43% in Japan for the manufacturing sector, while they have increased by 5% for the United States over the same period. Another way of getting an approximate measurement of the same phenomenon is to look at export price gaps. These paint an even more sharply contrasted picture (-48% for Japan and +46% for the US). However, the US achieved substantial productivity gains over the period, undoubtedly more so than Japan. So Japan's improved ability to compete is based more on low wage growth, and indirectly on deflation, that on improved productivity.

Asset allocation: biting the bullet

- Despite a much better than expected US ISM survey, our strategy team has decided to take stock of the much higher than usual uncertainties surrounding the US and global recoveries. We anticipate that the overall balance of good vs. bad news from real economies will be tilted on the downside over the next three to four months, for several reasons. First, global trade growth will continue to slow, as final demand in China and other large emerging economies is no more super-stimulated by budgetary and monetary amphetamines. Second, the powerful inventory cycle that has lifted up manufacturing production in most of the developed world since mid 2009 is coming to and end. Third, the room for further fiscal stimulus in OECD economies is razor thin. Unchanged fiscal policies would imply a transitory drag on GDP growth. All the more so in case of fiscal tightening.
- Don't get us wrong: we have not changed our fundamental view on the global recovery. We believe that robust structural demand from emerging economies, as well as structural and cyclical demand for new equipment from profitable companies all around the world, will continue to fuel the recovery in its more mature phase. We also believe that the painful deleveraging process at work in the US will cast a long shadow, although not as long as doomsayers say, on the overall performance of this economy.
- Yet, in the short term, risk aversion is likely to remain high, the odds for a further leg of the bond market rally are large and risky assets may suffer from macro and, in some cases (US, Italy) political uncertainties. We see a distinct possibility that US 10Y Treasuries yields fall to 2.0% and that 10Y Bund yields visit the 1.5% region. Already expensive from a fundamental perspective, safe haven sovereign bonds are still attractive, as long as the markets have not rejected the 'double dip' option. Hence, we are now overweight safe haven govies such as US Treasuries and German Bunds, while we are shifting our equity and high yield credit position to underweight. We remain overweight on investment grade credit and emerging market sovereign debt. We will give you a full update of our reshuffled asset allocation recommendation in next week's Strategy Monthly Letter.

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The yen's appreciation can also be analysed from the perspective of capital inflows and outflows. Since the beginning of the 1980's, Japan has systematically run a current account balance surplus fluctuating between 1.4% and 4.8% of its GDP. Today, the surplus stands at 3.4% of GDP, fed by both a cyclical component (goods and services trade surpluses) and, increasingly, by a structural component (income earned on assets held abroad by Japanese agents). In parallel, Japan exports capital via its direct investments, portfolio investments and its credit flows abroad, but not in sufficient quantities. Therefore, the balance of this current account surplus and these capital outflows – the variations in currency reserves – shows a recurrent increase in the latter. In other words, from a purely Japanese perspective, the recycling of Japan's excess savings abroad is not enough, leading to the appreciation of the yen versus the dollar.

The currency market is also influenced by non-resident and investor behaviour via the carry trades. Since 1999, Japan has maintained its short-term rates at close to zero, making the yen one of the currencies of choice for financing carry trade operations. The yen's depreciation against the dollar during the period 2005-2007 is mostly attributable to yield spreads, or more precisely to the difference between Japan's monetary policy (zero rate, quant easing) and that of the rest of the world (key rate hikes). With the financial crisis, monetary policy stances became noticeably more homogenous, with few exceptions (Australia was one such exception). Not only are yield spreads extremely slim today, but the prospect of spreads widening as the Western nations normalize policy is looking much less certain since the beginning of the year. The idea of borrowing in yen holds little appeal today.

The final factor behind the yen's appeal is that the market hates negative surprises—those that have not been factored into prices. Japan's financial situation holds no mystery and has not for some time. If there is a surprise in store, it will probably not be coming from the Archipelago. On the contrary, the fact that Japan is awash in savings constitutes an advantage over other countries, where the debt is not as high but where the national saving rate is too low (some Eurozone countries come to mind).

All in all, we think that the upward pressures on the yen versus the dollar will last until such time as Japan's Minister of Finance (MoF) decides to intervene. We think that the intervention threshold is close, around 80 yen.

Not much can be done to counter the yen's rise

The yen's rise against nearly every currency doubly penalizes the Japanese economy. Over a long period, it contributes to the reallocation of production factors to sectors that are not exposed to international competition—in other words, to deindustrialization. According to METI figures, the manufacturing output of Japanese companies abroad represented 17% of total production for the Archipelago in the course of fiscal year 2008, compared with 2.2% in 1983. Over the shorter term, by making Japanese products less price competitive, it leads exporting firms to increase their efforts in terms of productivity and wage control. In return, pressures on pay have an adverse impact on private consumption and help to maintain the deflationary dynamic. In addition, the yen's appreciation strengthens imported deflation. In the final analysis, the rise of the yen leads to stronger deflation and, ultimately, to deflation expectations once investors believe that the central bank does not wish to weaken its own currency or that it is unable to do so.

Japan really can't do much to influence the exchange rate of the yen. In late 2009, the market was still anticipating the start of the process of normalizing monetary policies in both the United States and the Eurozone sometime in 2010. Then, it was enough that the Bank of Japan (BoJ) announces, on December 1 of last year, that it was launching a new short-term credit program offering attractive conditions to provoke an at least temporary depreciation of the yen. Today, the Fed and the ECB are maintaining an explicitly accommodating bias, and the announced reinforcement of the December plan made on August 30 by the BoJ not surprisingly went nowhere.

In any case, the BoJ isn't behaving as if it really wants to actively counter the yen's appreciation. It seems that the ball is now in the court of the MoF, since it will have to decide whether to intervene or not. It is likely that, as the threshold of 80 yen approaches, the MoF will have to step in—massively, no doubt—but history teaches us that an intervention of this type that is not coordinated with other central banks is not very effective. Moreover, it would be a good thing if these interventions were not sterilized, in order to step up growth in money supply.

Conclusions

The yen's appreciation is at bottom both a cause and a consequence of Japan's deflation. The tools available to Japan's policy makers for countering this trend have lately lost much of their efficacy with the homogenization of monetary policy among the major developed economies and also in light of mounting uncertainties, with regard to the macroeconomic scenario and the stability of the international financial system. It is likely that the threshold of 80 yen for the dollar will trigger a direct intervention on the market, which should manage to stabilize the yen at between 85 and 90 by the end of this year. With the yen more expensive, exporters could have a more difficult time, but lower ULC in the manufacturing sector should be enough to keep the contribution of external trade to GDP growth in positive territory.

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